BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
W. K. AND KATHRYN MORGAN)

Appearances:

For Appellants: Archibald M. Mull, Jr., and
James W. Foley, Attorneys at Law

For Respondent: F. Edward Caine
Senior Counsel

O P I N I O N

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed sssessments of additional personal income tax against W. K. and Kathryn Morgan in the amounts of $34,194.25, $107,838.75, $126,712.64 and $96,426.98 for the years 1951, 1953, 1954 and 1955, respectively, against W. K. Morgan in the amount of $35,292.17 for the year 1952, and against Kathryn Morgan in the amount of $35,292.17 for the year 1952.

Appellant W. K. Morgan (hereafter referred to as appellant) conducted a coin machine business in the San Jose area under the name Bill Morgan Amusement Company. He owned bingo pinball machines, music machines and miscellaneous amusement machines. In 1955 he purchased and began operating cigarette machines. During the first part of the period under review he also owned a large number of slot machines which, however, were in a warehouse and were not being used.

The equipment was placed in some 230 locations. With one exception discussed below and with the exception of cigarette machines, the proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between appellant and the location owner. At one location where the building was owned by appellant, appellant permitted the occupant to operate a cafe in the building rent free and, in turn, appellant received the entire proceeds of the pinball machines.

The gross income reported in tax returns was, except as to cigarette machines, the total of amounts retained from locations. In the case of cigarette machines, the gross income reported in the tax return was the total amount of coins deposited in the machines less the cost of the cigarettes. Deductions were taken for depreciation, salaries, phonograph records and other business expenses. Respondent determined that appellant was renting space in the locations where his machines were placed and that all the coins deposited in the machines, other than cigarette machines, constituted gross income to him. No change was made in the reported gross income from cigarette machines. Respondent also disallowed all expenses pursuant to section 17297 (1735'9 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

> In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

The evidence indicates that the operating arrangements between appellant and each location owner were, with the exceptions described in the following two paragraphs, the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197 3, P-H State & Local Tax Serv. Cal. Par, 58145. Cur conclusion in Hall that the machine owner and each location owner were engaged in a joint venture is, accordingly, applicable here. Thus, only one-half of the amounts deposited in the machines operated under these arrangements were includible in appellant's gross income.

The pinball machines located in the building which appellant owned, on the other hand, were operated entirely on his behalf, in return for occupancy of the building. All of the amounts deposited in these machines were therefore includible in appellant's gross income.

The details of the arrangements with respect to the cigarette machines have not been presented to us. In the absence of evidence to the contrary, we conclude that the gorss income from these machines, as reported by appellant and accepted by respondent, was correct.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. 201-984, 2 P-H State & Local Tax Serv. Cal. Par, 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code sections 330b, 330.1 and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

The evidence indicates without contradiction that it was the general practice to pay cash to players of the pinball machines for unplayed free games, Accordingly, the pinball machine'phase of appellant's business was illegal, both on the ground of ownership and possession of bingo pinball machines which were predominantly games of chance and on the ground that cash was paid to winning players. Respondent was therefore correct in applying section 17297.

There was a pinball machine in virtually every location at which appellant had a cigarette machine, music machine or other type of amusement device? Appellant's repairmen repaired all types of machines. When the cigarette machines were first introduced, the most common method of placing them was to solicit locations in which appellant already had other equipment. Accordingly, the legal operation of music machines, miscellaneous amusement machines and cigarette machines was associated or connected in a substantial way with the illegal operation of pinball machines and respondent was correct in disallowing all the expenses of appellant's business.

There were no records of amounts paid to players of the pinball machines for unplayed free games. Respondent's auditor estimated that the cash payouts equaled 66 2/3 percent of the total amount deposited in the pinball machines. Although there was testimony that this percentage was based on interviews with eight location owners in 1955, estimates given at the hearing in this matter by six witnesses, including some of the persons previously interviewed, ranged from 10 to 40 percent. Bearing in mind that the estimates at this hearing were made long after the years under review and that respondent's finding of gross income carries a presumption of correctness, we nevertheless believe that the payout figure should be reduced to 50 percent.

Appellant's books did not segregate income from coin machine games and music machines according to type of machine. However, appellant did employ a separate collector for music machines and, therefore, there were separate collection reports for the music machine income. By a sampling of collection reports, respondent's auditor made a segregation of the music income. The balance of the income (other than the separately reported cigarette machine proceeds) he assumed to be from pinball machines. Included in such income was some amount from miscellaneous amusement machines such as shuffleboards, bowlers and guns, We believe some allowance should be made for this income. After examining the types of equipment listed in the depreciation schedules attached to appellant's tax returns, we conclude that of the total income attributed by respondent's auditor to pinball machines, 5 percent thereof should be considered to have been derived from equipment as to which there were no cash payouts.

A further adjustment is called for with respect to the pinball machines located in the building which appellant owned. Appellant reported the entire net proceeds of these machines. In reconstructing the gross income, however, respondent assumed that the occupant of the building

retained a share of the net proceeds and added the assumed share to appellant's income. Respondent has conceded that its assumption was erroneous,

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against W. K, and Kathryn Morgan in the amounts of $34,194.25, $107,838.75, $126,712.64 and $96,426.98 for the years 1951, 1953, 1954 and 1955, respectively, against W, K. Morgan in the amount of $35,292.17 for the year 1952, and against Kathryn Morgan in the amount of $35,292.17 for the year 1952, be modified in that the gross income is to be recomputed in accordance with the opinion of the board. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 5th day of February 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce Secretary